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News release



PUBLIC AND PRIVATE PENSIONS IN CANADA: AN ECONOMIC ANALYSIS, a research report prepared for the Ontario Economic Council by Dr. James E. Pesando and Dr. Samuel A. Rea, Jr., and published by the University of Toronto Press.

TORONTO, September 14, 1977 -- Government must take a more direct role in facilitating private saving for retirement by modifying the present pension system by fully funding the Canada Pension Plan, expanding CPP contributions and benefits, by improving regulations governing private plans, and by providing financial instruments to protect private pensions from erosion by inflation, according to a research report released today by the Ontario Economic Council.

In the study, titled Public and Private Pensions in Canada: an economic analysis, the authors address a variety of pension topics which have become of increasing concern in recent years, with the prime focus on the evaluation of government policies which affect, directly or indirectly, the provision of retirement incomes.

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The Canada Pension Plan fund should be larger and should purchase private sector securities, the report states. The CPP fund now purchases provincial debt rather than investing directly in private sector investment instruments. The study's authors, economics professors James E. Pesando and Samuel A. Rea, Jr., state that the purchase of provincial debt will lead to real investment only if provinces do not increase their current expenditure in response to readily available CPP funds.

The move to a larger CPP fund must be accompanied by a greater realization by the provinces that their obligations to the fund are real and that use of the money for current expenditure rather than investment purposes is not optimal. An increase in the interest rate paid by provinces to the fund might help to deter additional provincial expenditures, state Pesando and Rea.

CPP contribution rates will have to be increased eventually to cover future benefits, the authors state, and the only decisions to be made are how much and how soon. A lowered retirement age will require even greater increases in contribution rates or reductions in benefits if CPP financing is to remain on sound footing, believe Pesando and Rea. "It is not unreasonable for workers to wish to retire earlier," they state, "provided they are aware that they must give up some income in exchange for the added leisure."

Basic retirement benefit provisions in the CPP transfer a greater amount of wealth to persons with higher lifetime incomes because the plan is not actuarially sound. Placing the fund on a sound actuarial basis would eliminate this regressive effect, the authors of the study state, and would result in persons with low lifetime incomes receiving positive net benefits.

Wealth is now distributed away from single persons by the CPP plan and this effect will be increased if recent proposals to integrate housewives into the plan are adopted. This transfer of wealth occurs because contribution rates are identical for single and married contributors but married contributors receive additional benefits.

Liberalization of provisions to permit earlier vesting of private pensions may be an illusory gain, the authors state, because a young employee in a contributory defined benefit plan may pay virtually all of the cost of the deferred pension to which he becomes entitled.

The viability of private pension plans hinges upon their ability to provide adequate retirement incomes in an inflationary climate, state Pesando and Rea. Plans must preserve the real value of pension benefits both as they accumulate during working years and as they are paid out during retirement years. The authors conclude that 'final earnings' plans provide adequate protection during the accumulation period but full indexing is required to preserve the value of benefits during retirement.

Vesting of benefits of private pension plans ought to be full and immediate, the authors argue, because to the extent that benefits reflect employer contributions they are a form of deferred wages. Pesando and Rea recognize that adoption of this recommendation will likely produce effective wage grids which more sharply reward years of service, but they argue the cost to an employee who terminates will still be less than those imposed by delayed vesting regulations under the Ontario Pension Benefits Act of 1965.

Indexed government bonds and annuities which provide a fixed real interest rate would enable private pension plans to provide uneroded retirement benefits and yet remain actuarially sound, the authors state, but creation of such investment instruments would likely produce a major transformation of the Canadian financial system. A cautious examination of indexed investment vehicles by government would be valuable, the authors argue, to determine if their introduction could be made with minimal disruption of the capital market.

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The study was prepared under the auspices of the Ontario Economic Council, an autonomous research institute funded by the Province of Ontario. The Council acts as an independent advisor to government and all political parties, undertakes research and policy studies to encourage the optimum development of the human and material resources of Ontario and to support the advancement of all sectors of the Province. The Council achieves these goals by sponsorship of research projects, publication of studies, and organization of the Outlook and Issues conferences and seminars which are open to the public.

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NOTE: Authors' biographical sketches and selected quotations attached.

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Dr. James E. Pesando is Associate Professor of Economics and Research Associate, Institute for Policy Analysis, University of Toronto. He was educated at Harvard University (B.A.), the University of California at Berkley (M.A.), and the University of Toronto (Ph.D.). Dr. Pesando has researched and written articles on inflation, financial markets and economics for many business and economic publications and scholarly journals.

Dr. Samuel A. Rea, Jr. is Associate Professor of Economics and Research Associate, Institute for Policy Analysis, University of Toronto. He was educated at Harvard University where he was awarded an A.B. and Ph.D. Dr. Rea has researched and written articles for economics journals on human resources, welfare programs and income distribution.

SELECTED QUOTATIONS

"... The economic rationale for the 'locking-in' of both employee and employer contributions lies in the possible claim to income-tested, public retirement schemes if the worker fails to adequately save for his own retirement. The current regulations, however, may serve to penalize the member of an employer-sponsored private pension plan relative to the individual who saves for his own retirement in the form of an RRSP. ... The member of the employer-sponsored plan suffers by virtue of the fact that contributions made on his behalf are 'locked-in', while those of the individual who saves in the form of an RRSP are not." (Pg. 29)

"An analysis of income redistributive effects of inflation indicate that, for a typical defined benefit plan, the employee suffers a real wealth loss in both his pre-retirement and his post-retirement years. In general, the question of whether or not the employer would be a net beneficiary of this wealth transfer is ambiguous. If private pension plans, including those of the final earnings variety, could invest their funds in index bonds, then they could remain actuarially sound in an inflationary climate (i.e., they would not suffer an increase in experience deficiencies) and they could also provide for fully indexed pension benefits after retirement and yet continue to remain actuarially sound. The income redistributive effects of inflation, in the context of private pension plans, would disappear." (Pg. 48)

"In analysing the policy option of the government's issuing index bonds or in assessing the likelihood that private corporations may elect to issue index bonds, one must emphasize the far-reaching consequences of such action. The issuance of index bonds by the government, for example, could lead via competitive forces to the introduction of indexed financial instruments such as savings deposits, mortgages, and corporate bonds in the private sector. Indexation might quickly percolate through the financial system and ultimately produce a Canadian capital market which is distinctly different from the one that exists today." (Pg. 61)

"(Our examination) of the major programs affecting those over 65 indicates that there is no unified approach to the problem of providing retirement income. Certain of the provisions are progressive while others are regressive. The most striking characteristic of the combination of programs is that the contributory program, the CPP, provides relatively small retirement benefits in relation to the benefits available from other programs. Unless new legislation is introduced the CPP will gradually increase in importance because the benefits (and contributions) reflect real growth in earnings as well as price changes. Nevertheless, we can conclude that the existing public programs do not provide means by which individuals can save for their own retirement, but they may have a significant impact on the distribution of income." (Pg. 76)

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"The provinces are going to find that the cash flow from the CPP fund will become small even if an investment fund is created because of the projected slow-down in labour force growth. Ultimately new debt financing for the provinces will have to come from the capital market. Therefore, the provinces must sooner or later become independent of the CPP fund for new financing. The payment of market rates of interest may serve to emphasize the nature of the provincial obligation to the fund and deter additional expenditure. In addition, the CPP should follow Quebec's example by purchasing private securities with the CPP funds. This institutional arrangement would prevent additional CPP contributions from financing current government expenditures." (Pg. 93)

"The introduction of the CPP implicitly transferred wealth between various economic groups. An analysis of the redistributional effects indicated that the CPP offers higher net benefits to those with higher permanent incomes. This conclusion would be altered if contribution rates were significantly increased or a higher rate of discount were used. If the plan were actuarially sound over-all, it would offer negative net benefits to those with higher earnings and positive net benefits to those with lower earnings." (Pg. 117)

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"If contributions are increased ..., the CPP becomes less regressive, yet low income individuals will clearly bear an increased tax burden. This apparent contradiction can be explained if we realize that the alternative to a current increase in contribution rates is an even greater future increase. By increasing the burden on low income contributors today in order to fully fund the CPP, we will be relieving future low income contributors from the burden of supporting future pensioners. In order to achieve a fully-funded (progressive) system the tax burden must be increased on today's contributors." (Pg. 118)

"On balance the incentive effects of the existing structure of public pension programs are greatest for those with relatively low retirement incomes. Potential GAINS recipients will have no incentive to save for their retirement, and anyone who might otherwise work after age 65 for low annual earnings would be discouraged from working by the 100 per cent tax on private income." (Pg. 125)